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THE ENGLISH LAW OF CAPITAL AND INCOME

The writer has discussed the subject of capital and income in a series of articles in the *Law Quarterly Review*.¹ He now proposes to repeat what is there said so far as it may be likely to prove of interest to American lawyers.

I. UTILITY OF ECONOMIC CONCEPTS OF CAPITAL AND INCOME.

Neither economist, nor lawyer, handles goods, bills of exchange, bills of lading, charter-parties or insurance policies, yet both render services of supreme importance to business men by reducing their business affairs to scientific principles and evolving the sciences of economics and law.

What is capital or income from the economist's standpoint may in law be exactly opposite in result, nevertheless economic scientific theories, it is urged, are of considerable utility to the lawyer and will become more so as the principles of economics become enlarged and more adapted for application to business affairs in our everyday life.

(1) "Capital" used in a concrete sense.

The economist regards "capital" as concrete instruments of wealth, the lawyer and the business man more or less regard "capital" as expressed in terms of money. The economist, for example, envisages the capital employed in a business as consisting of its stock-in-trade, warehouses, and so forth. The business man when he speaks of his "capital" has in mind capital in the abstract, capital-value of his assets as disclosed by his balance sheet. "Capital" to him is an abstract thing, with the economist it consists of concrete conglomerate entities.

The principles of taxation belong essentially to economists and, it is urged, a really scientific income tax should be based on the economic concepts of capital and income, but carried into practical effect by experienced revenue experts and framed as a

¹ Economic and Legal Differentiation of Capital and Income, xxvi L. Q. R. 40 (and see xviii L. Q. R. 274). The Return of a Company's Capital to its Shareholders, xxvi L. Q. R. 231. Capital and Income (Lifeowner and Remainderman), xxviii L. Q. R. 175. Capital and Income under the Income Tax Acts, xxix L. Q. R. 163; and see first chapter of the writer's Digest of the Law of Trust Accounts.

legislative measure by skilled lawyers versed in all the intricacies of the legal system of the country imposing the income tax.

For example, in taxing income from land, the legal draftsman may find it advantageous to visualize the subject-matter as an economist probably would do; that is, he would conceive land to be an instrument of wealth, divided vertically into fee simple and lesser estates and interests, and horizontally into surface and substratum, the latter including mines, subways, and so forth, all capable of separate ownership and taxation.

Furnished with a scientific basis and profiting by the experience of revenue experts the legal draftsman would be more likely to construct an efficient fiscal net so designed that nothing should escape which was intended to be caught.

The economist's concept of capital as consisting of concrete things is very valuable in giving effect to the principle of taxation of income "at the source," a method which is calculated to avoid taxing the same subject-matter twice, which happens under some systems. Four-fifths of the English income tax is assessed on this plan and it is said to be one of the chief causes of its success.²

The legislator would proceed on the principle of regarding various instruments of wealth as "capital" with a view to taxing the flow of income therefrom. He would also consider human beings as a species of capital, as many economists do, the fees of a professional singer, or of a state official would therefore be taxed as income.

He would then provide machinery for taxing income "at the source," namely, at the point whence it flows from the "capital" which produces it. Then having taxed "at the source" the recipient of the income, further machinery will be required by which that person shall be enabled to recover a ratable proportion from all other persons who benefit by the income stream. Thus under the English system the income (the rent) of a house is taxed "at the source." The occupier is assessed as the person in receipt of the income. Then the occupier in paying his rent

² *The Income Tax*, p. 216. Professor Seligman, Columbia University. The Macmillan Co., New York (1911).

deducts the tax from the landlord. The landlord in turn deducts a ratable proportion from other persons who derive income (the rent) from the capital (the house). Thus, if the tax is levied at the rate 1/- in the pound he deducts tax at that rate from the outgoings he has to pay to a mortgagee for interest, to a rent-charger, portioner or any other legal participant of any part of the income flow.

If the economist's distinction between "capital" used in an abstract or concrete sense had been borne in mind some confusion on an important topic of English law would have been avoided.

It seems to have been assumed at one time that all concrete assets belonging to a company became in some way its "capital" and could not be converted into cash and distributed as dividends.

The case of *Lubbock v. British Bank of South America*³ affords a good illustration of that view. A bank had sold part of its assets for a large sum and proposed to divide the profit. Thereupon a shareholder applied for an injunction to restrain the company from dividing the profit "as if it were income." The judge refused to listen to the shareholder and in the course of his decision pointed out the fallacious reasoning resulting from using "capital" in an abstract and "capital" in a concrete sense. After alluding to the argument of the plaintiff that the portion of the bank assets sold "was part of the capital of the company . . . an accretion to capital, therefore it must be kept intact as part of the capital," he observed:

"The capital that has to be regarded for the purposes of the Act of Parliament is the capital according to the Act ⁴ and not the things; whether houses, goods, boots or shoes, or hats, or whatever it may be for the time being representing the capital, in the sense of being things in which the capital has been laid out."

The writer has summed up his view of the English law on this subject, as it now stands, as follows:⁵

³ (1892) 2 Ch. 198.

⁴ *I. e.*, the subscribed cash capital.

⁵ xxvi L. Q. R. 237.

"Pretermitted doubtful cases where an application to the court is expedient, the general conclusion appears to be, assuming that the directors act as honest and reasonably prudent men should act, that a company can deal with assets relating to its capital and revenue accounts either as capital or income, or *vice versa*, in any way it thinks proper with this exception that it cannot (unless authorized by order of court) convert into cash assets representing or which should represent its subscribed capital and return such subscribed capital to the shareholders, since that would violate the implied basis of rights respectively existing between the company and its shareholders and the company and its creditors."

(2) "Capital" used in an abstract sense ("Capital Value").

When a lawyer, or business man, speaks of the "capital" of the Pennsylvania Railroad, he pictures a vast sum representing in dollars the value of the assets of that concern; in other words, its "capital value." What the economist has in view as "capital" are the items of concrete things which form the greater part of the company's assets.

We learn from the economist that "capital value" is the discounted or present value reckoned at a given time of the expected income from the capital. A trustee is often embarrassed by the question from a beneficiary whether the values of his trust investments are likely to rise to those of some decades ago. Remembering the economic explanation he will reply, "I can answer your question if you will tell me the general market level of interest at the date you have in mind." "Capital value" rises or falls according to the expected value of the income. If the rate of interest is high "capital value" will be assessed as a lesser number of years purchase than if it is low. A high rate of income return therefore means diminished "capital value." A low rate increases the "capital value."

(3) Economic Differentiation of Capital and Income.

The following definitions modified to meet essential differences in Economics and Law are founded with his approval on the work⁶ of Professor Irving Fisher, of Yale, the leading economist on the subject:

⁶The Nature of Capital and Income. The Macmillan Co., New York (1906).

Capital is a fund. Income is a flow. A fund of property existing at an instant of time is called capital. A flow of services rendered by that capital, for instance, by the payment of money from it, or any other benefit rendered by a fund of capital in relation to such fund through a period of times is called income.⁷

Capital then is a "fund" and income a "flow" from it and in considering the question when a flow arises and becomes income it will assist us if we keep in mind Professor Fisher's notion of "detachment."

His thesis is that an increase in "capital value" remains capital until it is detached.⁸ For example, the profits of a trader's business consist of the increase in capital-value of the trader's stock-in-trade between two given dates.⁹

After ascertainment and detachment they become income. So in regard to the profits of a company. In the shape of a dividend we easily recognize it as income. What has really happened is that the "capital values" of the company's assets have increased and when the stockholder cashes his dividends his share of "capital values" is detached and becomes income. The economic theory of "fund" and "flow" and the notion of detachment are, it is suggested, very helpful to the lawyer, but what, let us inquire, is the *legal* aspect of the differentiation of capital and income?

The writer submits that in law after detachment has arisen the question of whether the detached portion shall be capital or income resolves itself into one of fact, the relation of the parties, the particular circumstances of the matter and general usage and custom all being possible determinants in arriving at a legal conclusion.

⁷ Illustration: A owns a house (capital). The flow of services rendered by that capital to A in shelter or rent is income.

⁸ Compare the following passage from *Smith v. Hooper*, 95 Md. 16 (1902), cited in E. A. Howes' *The American Law Relating to Income and Principal*: "Increase and Income are not synonymous terms. Until detached or separated from the shares whose value it enhances increase forms part of that value and therefore part of the shares and if it be part of the shares themselves then whilst it may be profit it is in no sense income."

⁹ A judicial definition of "profit" in *In re Spanish Prospecting Co., Lim.* (1911), 1 Ch. 98, is to the same effect.

If a doctor made a profit by speculating in stock, the business man's probable inference would be that it should be regarded as capital, whereas the same profits made by a stock jobber would be regarded as income of his business. The same inference as in regard to the doctor would arise as to profits made by a company from the sale of land when its business did not comprise dealing in that commodity.¹⁰ In further illustration of the writer's conclusion that in law inferences as to what is to be regarded as capital and what as income are to be drawn from the particular circumstances of the case, we may select the examples of terminable annuities and mineral royalties.

Instalments of a terminable annuity are as between lifeowner and remainderman, wasting capital and must be invested,¹¹ the former only taking the income of the investment (unless the intention of the donor of the annuity is otherwise). But a terminable annuity is under the English Income Tax Acts taxable as income.

Likewise royalties from minerals are in their nature "capital," the fund of capital being gradually depleted as the minerals are worked out and usually as regards a lifeowner of the minerals must be invested as *capital*,¹² unless the donor of them intends the lifeowner to enjoy the royalties in specie as income, but under the English Income Tax Acts they are taxed as income.

There are some other topics relating to the economic aspect of our subject to which the writer is desirous of alluding. A flow of income may be perpetual or may consist of a single jet, a legal example of the latter is an exceptional bonus dividend taken by a lifeowner of the stock in respect of which it is paid. Or it may flow at definite, or indefinite periods, legal examples of which are timber "thinnings" arising perhaps at long intervals, or it may be intermittent as in the case of copyhold "fines."

¹⁰ *Stevens v. Hudson Bay Co.*, 101 L. T. 96 (1909). Cf. Dividends of land companies and profit on a sale of bonds, as between lifeowner and remainderman. *The American Law Relating to Income and Principal*, pp. 16, 38.

¹¹ *Crawley v. Crawley*, 4 L. J. Ch. 265; 40 R. R. 170 (1835).

¹² *In re Ridge* (1884), 31 Ch. D. 508. Cf. *The American Law Relating to Income and Principal*, p. 5.

From Professor Fisher we may learn to avoid confusion in speaking of income by calling the actual income detached from capital "actual" income to distinguish it from other kinds of income. For example, the rent of a house to which a lifeowner is entitled is "actual" income, but under English law income from unauthorized investments yielding say twenty *per cent.* will not belong to the lifeowner, he will be entitled to a lesser income than the "actual" income paid by the company, the balance being invested as capital.

Finally, in regarding income as a flow, time, "that great independent variable of human experience," to use Professor Fisher's words, has to be reckoned with. Thus when a testator dies every asset forms part of his capital at his death, therefore interest due on a debt at that date ceases to be income and must be taken to be capital of his estate.

II. CAPITAL AND INCOME AS BETWEEN LIFEOWNER AND REMAINDERMAN.

Questions of capital or income arise more frequently under this branch of law than under any other, which is not surprising when one remembers the vast wealth held for persons having successive interests.

It might have been supposed that some clear, definite principle would have been laid down, followed and applied in succeeding decisions as a means of distinguishing capital and income where, as under English law, lifeowner and remainderman are concerned, but this is not so.

The writer submits that the broad principle which should regulate these questions is *the presumed intention of the donor*. This was clearly the principle applied by a very distinguished judge, Lord Lindley, whose *dicta* will be quoted later.

The principle now contended for as the basal one which should govern has been enunciated in decisions relating to (1) royalties from opened mines; (2) timber thinnings, and (3) bonuses paid by public companies.

In regard to the first line of cases, Lord Blackburn,¹³ after referring to Lord Coke as an authority, has said:

"I am inclined to agree . . . that the original ground of all that was that there was supposed to be an irresistible indication of intention that he who conveyed the property for a limited time to a person with a limited interest intended him to work the opened minerals. I am inclined to think that it was upon that ground that the Courts originally acted throughout, and I quite agree . . . that where there is a sufficient appearance of intention in the instrument to show either that that should be restricted, or that it should be extended that intention would govern."

As regards the second line of cases, Lord Justice Bowen¹⁴ has said:

"The open mine does not constitute an arbitrary exception to real property law. It is merely a well-known principle of construction in virtue of which grants of mineral land are given such force and effect as is reasonably necessary to carry out the obvious intention of the grantor. The grantor was absolute master of his property and could carve the lands which were the subject of his grant into such estates and interests as he pleased. It is therefore from his presumed will and intention that the result in the case of the open mine follows."

Then Lord Lindley in a case¹⁵ falling within the third class of decisions laid down what the writer submits is the broad, and should be the governing, principle. His Lordship was dealing with the question whether a certain payment made by a public company in respect to shares in it which were held for a life-owner and remainderman was to be regarded as capital or income:

"What does a man mean when he leaves shares to a tenant for life? He means that that tenant for life shall have the income arising from the shares in the shape of dividends or bonuses declared during the lifetime of the tenant for life. He does not mean that the tenant for life shall receive profits in any other sense. He does not mean him to have such profits, for example, as arise by a realization of shares. He never

¹³ *Campbell v. Wardlaw*, 8 App. Cas. 645 (1883).

¹⁴ *Dashwood v. Magniac* (1891), 3 Ch. 360.

¹⁵ *In re Armitage* (1893), 3 Ch. 337, 346.

dreamed of such profits going to the tenant for life. What he means is that the tenant for life shall have the income derived from the dividends or bonuses declared by the company."

Now let us apply Lord Lindley's test of the *donor's intention* to the following decided cases.

Illustrations.¹⁶

(1) A company in order to equalize dividends declares them at a uniform rate, accumulates the surplus profits and from time to time distributes them as "bonus dividends." The dividends are income.

(2) A company increases its capital by issuing new shares of £10 and appropriates £7. 10. *per share* out of accumulated profits in part payment of them. Shares allotted to the trustees of a testator's estate (who hold for persons in succession) and thus paid for, are capital.¹⁷

(3) A company declares a bonus dividend out of accumulated profits, payable in cash, with an option to apply the dividend in payment of calls on new shares. It was the intention to declare the whole amount as dividend, but to make provision by which some of it would be capitalized. The sum paid is income.¹⁸

(4) A company has sold its other assets to another company, being in liquidation. The liquidator pays the proceeds of certain assets, representing accumulated profits, not capitalized, to its shareholders including the trustees of a will who hold in trust for A for life. Such payment is capital.¹⁹

¹⁶ For further illustrations see the writer's Digest of the Law of Trust Accounts, p. 15.

¹⁷ *Bouch v. Sproule*, 12 App. Cas. 385 (1887). Cf. Pennsylvania, New York and Massachusetts rules as to "stock dividends," see Law of Income and Principal, p. 26.

¹⁸ *In re Northage*, 64 L. T. 625 (1891). Cf. the Pennsylvania rule of apportionment and the Massachusetts rule against apportionment of extra dividends and as to option to take cash or new stock, see The Law of Income and Principal, p. 22. In English law the action of the company or partners is the legal determinant. What is paid as dividend is income, what is treated by the company as capital is regarded as such between lifeowner and remainderman. See Digest of the Law of Trust Accounts, chap. 6.

¹⁹ *In re Armitage*, *supra*, note 15.

(5) Trustees elected directors of a company by virtue of shares held by them in trust receive fees as such directors. The fees are capital.²⁰

(6) Compensation is paid for a release of restrictive covenants,²¹ and of rights attached to a company's shares.²² The sums received are capital.

The decisions in the above illustrations rest on various grounds, but it is submitted that when Lord Lindley's simple but invaluable test of the *donor's presumed intention* is applied the result in each of the above instances will accord with that judicially arrived at. Under some circumstances the item in dispute may be income, but in the above illustrations, except the first and third, it is inferred that in each case the item is not such income as the donor intended the lifeowner to take.

In applying this test it is submitted that where "intention is a matter of inference usage becomes all important"²³ and the writer would suggest that usage seems to treat ordinary or recurrent flows as income, whilst extraordinary or discontinuous items are usually regarded as capital. The following definitions of capital and income, where the relation of lifeowner and remainderman exists, are based on what has been mentioned in this article:

(1) "Income" as between lifeowner and remainderman includes such property or proprietary rights belonging to the trust estate as the lifeowner is entitled to by the express or implied²⁴ terms of the trust instrument, by legal intendment,²⁵ by the action of third parties,²⁶ by statute,²⁷ custom usage,²⁸ or otherwise.

²⁰ *In re Francis*, 92 L. T. 77 (1905).

²¹ *Cowley v. Wellesley*, 35 Beav. 640 (1866).

²² *Bates v. Mackinley*, 31 L. J. Ch. 389 (1862).

²³ *Dashwood v. Magniac*, *supra*, note 14.

²⁴ *I. e.*, the donor's presumed intention.

²⁵ *E. g.*, right of a tenant by the curtesy to work an open mine.

²⁶ *E. g.*, partners, or a company.

²⁷ *E. g.*, lease fines under Settled Land Acts.

²⁸ See above.

(2) "Capital" as between lifeowner and remainderman is any proprietary right belonging to the trust estate to which the lifeowner is not entitled.²⁹

The writer submits the following conclusions as the result of what has been discussed in the present article in regard to the subject of capital and income:

(1) From the eminent economist who has been mentioned, the lawyer may learn to avoid error by recognizing that "capital" may connote either concrete things, or "capital value" (that is, the monetary values of them); that capital is a "fund" and "income" a detachment or flow from that fund.

(2) Whether in law a particular item is capital or is income is a question of fact to be inferred from the particular circumstances.

(3) That in deciding the question of fact, where the relation of lifeowner and remainderman exists, the sound principle to apply is to inquire whether the donor's probable intention was that the item in question should go to the lifeowner or be regarded as capital.

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²⁹ "*Prima facie* it must be capital unless you can say that it is income in some way." *In re Francis*, *supra*, note 20.